EXECUTIVE SECRETARIAT

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15	D/PAO				
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17	AO/DCI				
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19	VC/NIC		X w/o att		
20	NIO/ECON	X w/att			
21	ES		X w/o att		
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Executive Secretary

______ Date

Not referred to DOC. Waiver

3637 (10-81)

1 May 1984

MEMORANDUM FOR: National Intelligence Officer for Economics

FROM: Director of Central Intelligence

SUBJECT: Capital Flows

Ken Dam handed me this at lunch on Friday and asked what kind of work the Agency does on capital flows. If you can prepare a short response I will send it on to him.

William J. Casey

UNITED STATES DEPARTMENT OF COMMERCE
The Under Secretary for International Trade
Washington, D.C. 20230

'84 APR 26 P3:13

APR 23 1984

Honorable Kenneth W. Dam
Deputy Secretary of State
Department of State
Washington, D. C. 20520

Dear Ken,

Enclosed is a copy of an analysis of recent U.S. international capital flows with detailed consideration of the European Community. This analysis had its genesis in recent discussions I have had with the members of the European Parliament's Committee on External Relations.

The analysis in the paper focuses on several popular notions raised in recent months by European economic leaders. In summary, the conclusion is reached that given the small level of U.S. net capital inflows relative to capital formation in the world economy during 1980-1983, investment levels could not have been materially retarded. Moreover, the analysis reviews levels of U.S. lending to the EC between 1981 and 1983 and finds the EC a capital importer from the United States until late 1983.

Should you have any questions or comments, please let me know.

Sincerely,

Lionel

Lionel H. Olmer

Enclosure

ITA

UNITED STATES-EC

CAPITAL FLOWS

1980-1984

IEP STAFF STUDY

Prepared by: Charles M. Ludolph
Office of the European Community
EC Policy Division
March 1984

NOTE: This paper does not necessarily represent the position of the U.S. Department of Commerce, but is circulated to stimulate discussion and critical comment.

U.S. DEPARTMENT OF COMMERCE
International Trade Administration

A. EXECUTIVE SUMMARY

Recently there has been an increasing level of concern on the part of Europeans that the strong U.S. dollar and high levels of U.S. interest rates are having a direct effect upon the European economic recovery.

The magnitude of such concerns can be seen in a recent statement to the Congress of European Socialist Movement by French Finance Minister Delors. He stated that $150 billion had "flown" to the United States in 1983 and that he expected such flows to be as much as $300 billion by 1988.

- An examination of U.S. capital flows for 1979-1983 shows that in general, while recent trends in the current balance of payments indicate that the EC may become a net lender to the United States in 1984, between 1979 and 1983 capital was flowing out of the United States to Europe.

- Global net private capital inflows into the United States were more moderate than believed by Europeans, i.e., $20.5 billion in 1982 and about $45 billion in 1983. This is much lower than Delors' estimate of $150 billion in 1983 and hardly enough to materially affect investment in the world. For example, gross fixed capital formation in the OECD countries, not including the United States, in 1982 was about $1.2 trillion.

- While the United States was a net capital importer from the world in 1982 and 1983, it was, during the same period, a net capital exporter to Europe. In point of fact, during 1980-1983 the United States exported about $8-$10 billion in net private capital annually to Europe--mostly short-term funds seeking slightly higher interest rates during a period of flat loan demand in the United States.

- At the same time, EC long-term funds in the form of direct investment purchases of securities have flowed into the United States at a rate of $6-$8 billion in 1981 and 1982. These long-term flows have subsided in the second quarter of 1983 and thereafter. Again, this magnitude of outflow from Europe to the United States hardly seems sufficient to retard investment growth.

B. BACKGROUND

While recent U.S.-EC economic and commercial relations have been marred by disputes on trade in agriculture and basic industrial products, an underlying source of bilateral concern has been the poor performance of the European economies characterized by slow growth and weak recovery from the recent recession. The bilateral concern has been heightened by the contention of some Europeans that the recovery in Europe has been delayed and economic growth slowed by U.S. monetary and fiscal policies during 1980-1983. In the last three to four years, these European concerns have focused on the value of the U.S. dollar relative to most European currencies; however, recently there has been an increasing interest in the level of U.S. interest rates and their direct effect upon the European recovery.

European concern for these trends has heightened and can be seen in recent French suggestions that consideration should be given to penalizing European capital expatriated to the United States. In a recent statement to the Congress of European Socialist Movement, French Finance Minister Delors stated that $150 billion had "flown" to the United States in 1983 and that he expected such flows to be as much as $300 billion by 1988.

Moreover, Andreas Papandreau, the Greek Prime Minister and until recently President of the European Council, gave word to the concerns for the alleged drain on European liquidity and savings caused by the high U.S. interest rates and the supposed check on recovery and growth in Europe by insisting that "it is up to us to defend against further losses of liquidity which is very much needed for our recovery.... (to) put an end to this unproductive capital flow and to facilitate the return of European capital to Europe...is fundamental for reestablishing European prosperity...."

This paper takes a close look at the allegation that significant amounts of European capital have been attracted into the United States in recent years.

C. U.S. CAPITAL FLOWS

An examination of U.S. capital flows as summarized in the U.S. balance of payments gives direct indication of the relative significance of specific types of capital flows between the U.S. and the world. The figures in Table I present trends in international capital flows between the United States and the world during the period 1975-1983. The figures in each column present the level of net flows into the U.S. (inflows) and out of the U.S. (outflows) for an average quarter year during 1975-1979 for four major categories of investment, i.e., direct investment, purchases of securities, flows of non-banks, flows of banks. As indicated in the note to the table, inflows are generally represented as a positive number and show the magnitude of the net flow into the United States of foreign capital in various forms. Similarly, outflows represent U.S. investment overseas in the form of claims on foreign assets and other forms of U.S. capital flows to the world.

It should be understood at the outset that the accounting for capital flows is subject to problems of under-reporting and other errors and omissions and that the statistical discrepancy category reflects the magnitude of the flows in the current or capital account not directly accounted for in the balance of payments categories. Further, although there is some controversy as to how much of the statistical discrepancy is attributable to errors in the current account or capital account, it is widely accepted that such errors in recent years have grown sharply and are more probably attributable to the capital account. Analytically, this is the conservative approach for examining European concerns since such treatment would imply U.S. capital inflows. At the same time, while this shows what might be the worst case, it should be remembered that the dollar's importance as a reserve currency increases the chance that third country transfers of capital through Europe make it very difficult to interpret errors and omissions of these accounts on a geographic basis.

Examination of figures in Table I shows some interesting differences in trends of the various categories of U.S. capital flows with the world between 1975-1979 and 1980-1983.

For example, on a net basis, the average quarterly direct investment capital flow in 1975-1979 was substantially outward amounting to a total flow per quarter of $2.4 billion per quarter or almost $10 billion per year during 1975-1979. By 1982, this category of outflow had stopped and the U.S. experienced its first year of net direct investment inflow from the world in the post-World War II era. By 1983, the net inflows were slowing sharply due to economic recovery, and in 1980-1983 a substantial portion of net inflows in direct investments reflected large borrowings in Eurobonds by U.S. parent companies through their finance affiliates in the Netherlands Antilles.

These capital flows include purchases of plant and equipment, working capital, inventory financing, as well as exchange rate speculation and various other categories of capital transfers. These flows are influenced by the response of entrepreneurs to changes in interest rates and interest rate differentials between financial markets, as well as economic recession, inflation, and poor domestic sales. In addition, the effect of policy changes and deflation also had impact for the real rate of return on productive assets in the United States which also contributed to trends in direct-investment flows in 1980-1983.

A disaggregation of these trends in direct investment by category shows that the most important contributor to this reversal in flows was the steady U.S. disinvestment and repatriation of foreign equity and inter-company accounts indicated by the positive quarterly figures in the outflows in the equity category. It is also noteworthy that foreign equity flows in the United States grew substantially from an average of $1.0 billion per quarter in 1975-1979 to almost $3.0 billion per quarter in 1980-1982.

Capital flows reported by U.S. non-banking concerns involve mostly short-term debt and a significant portion of it are trade credits. The increase in the volume of U.S. international trade and the trade deficit contributed to making this account a substantial inflow in 1981-1983 rather than a small net outflow as was the case in 1975-1979.

Short-term capital flows reported by U.S. banks have been substantially outward since 1975. Only in second quarter 1983 do we see a net inflow of short-term funds. Moreover, levels of net flows both in and out of the country were surprisingly large, particularly from third quarter 1982 through third quarter 1983-- a period of extreme short-term interest rate volatility and variability. During these five quarters, $150 billion was loaned overseas in short-term instruments by U.S. investors and an equally remarkable $100 million was loaned in the United States by foreigners. It is also noteworthy that these flows were particularly sensitive to differentials in short-term interest rates, as well as poor banking conditions, e.g., plagued with weak assets and increasing loan-loss reserves.

In the aggregate, it can be seen from the total net private capital flows, which do or do not include the U.S. capital inflows implied by the statistical discrepancy, that beginning in 1983 under the latter concept or beginning in 1982 under the former concept, the U.S. experienced total net private capital inflows ranging from $1 to $5 billion per quarter from the world--most of which is attributable more to a decline in the flow of U.S. short-term investment abroad as an increase in foreign investment in the U.S. That is, by 1983 there was a shift to a capital inflow into the United States because there was an absence of foreign demand for dollar credits and a strong demand by U.S. banks for funds.

The information in Table II summarizes exactly the same categories of capital flows over the same time period, except that this table presents the net private international capital flows between the United States and the European Community. In this table, we see similar trends in long-term investment flows between the United States and Europe as in the previous analysis of flows between the U.S. and the world. As long-term interest rate differentials began to favor investment in the United States, Europeans increased their quarterly average direct investment from $1.2 billion per quarter in 1975-1979 to $1.5 billion during 1980-1983. Similarly, purchases of securities increased from about $350 million per quarter in 1975-1979 to about $1.3 billion per quarter in 1981-1983.

U.S. long-term outflows declined during the same period to a negligible level in 1982-1983. This indicates that during the period of large, long-term interest rates differences between the U.S. and Europe, the U.S. experienced, at most, an increase of $6 billion net inflow per year from Europe in long-term capital.

Short-term capital flows between the United States and Europe were substantial and grew significantly in 1981-1983. Until late 1982, short-term capital flows reported by U.S. banks were largely toward the higher interest rates in Europe, which began in 1980-81, peaked in 1982, but continued through 1983. Beside the outflow of U.S. capital reported by U.S. banks, it is also noteworthy that "foreign" inflows reversed during 1980-1981. This not only reflects trends in the potential returns on short-term investment but also is a by-product of the nature of accounting in this category of capital flows. Since foreign branches of U.S. banks are considered foreign investors for this accounting, much of the claims reported by U.S. banks reflect the interest of their foreign branches. Thus, beginning in the second quarter of 1980 not only did the outward flow of U.S. assets increase substantially, but "foreigners," mainly foreign branches of U.S. banks, disinvested. This trend continued until late 1981 and early 1982, when outflows of U.S. capital began to abate and were mainly attributable to the simultaneous decline of the differential in short-term interest rates and the sharp decline in the level of loans to LDCs.

The result of these trends is that during 1980-1983 U.S.-European capital accounts can be characterized as consistently an outflow, particularly in the form of short-term investment in the Eurodollar market.

TABLE I

PRIVATE SECTOR INTERNATIONAL CAPITAL FLOWS: U.S.-WORLD

(1975-1983) 1/

(billions $)

	1975-79 2/	1980				1981				1982				1983	
		I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II
Total Net Private Without Statistical Discrepancy	-5.0	+6.3	-24.6	-12.2	-6.3	-15.2	-2.8	7.1	-15.7	2.0	-8.5	-7.4	-7.1	-3.4	na
Total Net Private With Statistical Discrepancy	-0.4	12.6	-7.8	-6.3	-5.7	-8.1	3.4	8.9	-8.7	6.5	-1.5	8.9	6.6	5.6	na
Direct Investment															
Equity and Intercompany Accounts															
Inflows	1.0	0.9	2.8	0.2	0.7	1.6	3.4	3.4	8.5	1.9	2.9	2.8	2.9	2.0	1.1
Outflows	-1.3	0.4	1.0	0.5	-3.5	1.9	-1.7	1.7	2.3	0.7	2.4	1.7	3.6	1.4	2.4
Reinvested Earnings of Incorporated Affiliates															
Inflows	0.6	1.3	1.1	2.5	1.4	1.0	1.2	1.1	0.9	0.1	0.0	-0.2	-0.2	0.0	0.4
Outflows	-2.7	-5.9	-3.9	-3.8	-3.4	-4.0	-3.5	-2.3	-3.1	-1.3	-1.1	-1.2	-1.7	-1.1	-2.9
Purchase of Securities (Stocks, Bonds, etc.)															
Inflow	1.1	5.7	-0.8	0.0	3.1	3.9	4.3	0.3	1.6	2.6	4.5	1.8	4.2	5.9	5.4
Outflow	-1.4	-0.8	-1.3	-0.8	-0.4	-0.5	-1.5	-0.6	-2.8	-0.6	-0.5	-3.3	-3.5	-1.8	-3.2
Claims and Liabilities by U.S. non-Banks															
Inflows	0.2	0.4	1.1	0.4	3.2	-0.8	-0.2	1.0	-0.5	-0.2	-2.5	-0.4	0.0	-2.1	na
Outflows	-0.6	-1.1	0.1	0.3	-2.0	-3.2	2.5	0.9	-0.5	3.9	-0.3	1.0	2.3	-2.4	na

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	1975-79 2/	1980 I	1980 II	1980 III	1980 IV	1981 I	1981 II	1981 III	1981 IV	1982 I	1982 II	1982 III	1982 IV	1983 I	1983 II
Claims and Liabilities Reported by U.S. Banks															
Inflows.	3.4	6.6	-4.5	0.9	7.7	-3.9	7.7	16.9	20.5	25.7	24.8	11.0	2.8	10.6	1.1
Outflows	-5.3	-1.2	-20.2	-12.4	-13.1	-11.2	-15.0	-15.3	-42.6	-32.6	-38.7	-20.6	-17.5	-15.9	3.5
Statistical Discrepancy 3/	4.6	6.3	16.8	5.9	0.6	7.1	6.2	1.8	7.0	4.5	7.0	16.3	13.6	9.0	-0.4

1/ Inflows represent flows of non-official private foreign investment into the U.S. Typically denoted by a positive number, a negative sign (-) on an inflow represents a disinvestment on the part of foreigners. Outflows represent flows of non-official private U.S. capital to foreign investments. Typically represented by a negative sign, a positive outflow denotes a net disinvestment of U.S. claims on foreign assets and a return of U.S. capital to the U.S. In summary, a negative sign means an outflow of capital from the United States, by whoever owns it.

2/ 5 year simple quarterly average.

3/ Difference between current account balance and capital account balance.

Source: Bureau of Economic Analysis, Survey of Current Business, June 1981, December 1982, December 1983.

TABLE II

PRIVATE SECTOR INTERNATIONAL CAPITAL FLOWS: U.S.-EC

(1975-1983) 1/

(billions $)

	1975-79 2/	1980 I	1980 II	1980 III	1980 IV	1981 I	1981 II	1981 III	1981 IV	1982 I	1982 II	1982 III	1982 IV	1983 I	1983 II
Total Net Private Without Statistical Discrepancy	1.7	-1.0	-8.6	1.4	-2.6	-4.8	-7.3	-0.3	-2.0	-3.3	-5.0	3.3	-9.2	-1.8	na
Total Net Private With Statistical Discrepancy	0.4	-5.9	-4.8	-2.7	-0.2	-5.7	-1.0	-0.1	-3.9	-2.4	-1.1	1.1	-1.3	-0.1	na
Direct Investment															
Equity and Intercompany Accounts															
Inflows	0.73	0.5	1.9	0.2	-0.5	0.5	1.4	2.2	4.3	2.4	1.1	1.5	1.8	1.0	0.4
Outflows	-0.4	-0.1	-0.6	-0.4	-3.4	1.8	-2.2	1.2	0.3	-0.6	0.0	0.7	0.1	0.0	-0.1
Reinvested Earnings of Incorporated Affiliates															
Inflows	0.45	0.8	0.7	0.8	1.0	0.7	0.7	0.8	0.8	0.2	0.1	0.1	0.1	0.2	0.4
Outflows	-1.3	-2.9	-0.9	1.2	-1.0	-1.3	-0.5	-0.5	-1.3	-0.3	0.1	0.3	-0.7	-0.1	-1.4
Purchase of Securities (Stocks, Bonds, etc.)															
Inflow	0.35	1.1	0.7	0.5	1.2	1.6	2.0	0.7	0.5	1.1	2.0	0.9	1.2	1.7	0.4
Outflow	-2.25	-0.1	-0.6	-0.2	-0.1	-0.2	-0.1	0.1	-0.5	0.1	-0.8	-0.4	-1.5	-1.0	-1.5
Claims and Liabilities Reported by U.S. non-Banks															
Inflow	0.03	0.2	0.8	0.05	0.7	-0.4	-0.2	1.4	-1.4	1.1	-1.4	0.5	-0.5	-0.2	na
Outflow	-0.2	0.5	0.1	0.2	-1.1	-0.2	1.2	0.5	0.3	0.2	0.1	-0.1	0.7	-1.3	na

	1975-79 2/	1980				1981				1982				1983	
		I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II
Claims and Liabilities Reported by U.S. Banks															
Inflow	2.9	-0.9	-4.6	-0.5	2.5	-1.9	-6.1	-2.8	1.9	4.6	5.3	8.4	-1.7	1.4	2.8
Outflow	1.4	0.8	-6.1	1.9	-1.9	-5.4	-3.5	-3.9	-6.9	-12.1	-7.0	-8.6	-8.7	-3.5	5.6
Statistical Discrepancy	-2.1	-4.9	3.8	-4.1	2.4	-0.9	6.3	0.4	-1.9	0.9	-0.6	-2.2	7.9	1.7	-5.9

1/ Inflows represent flows of non-official private foreign investment into the U.S. Typically denoted by a positive number, a negative sign (-) on an inflow represents a disinvestment on the part of foreigners. Outflows represent flows of non-official private U.S. capital to foreign investments. Typically represented by a negative sign, a positive outflow denotes a net disinvestment of U.S. claims on foreign assets and a return of U.S. capital to the U.S. In summary, a negative sign means an outflow of capital from the United States, by whoever owns it.

2/ 5 year simple quarterly average.

3/ Difference between current account balance and capital account balance.

Source: Bureau of Economic Analysis, Survey of Current Business, June 1981, December 1982, December 1983.